TD Securities
Economics Strategy

Market Musings

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Quiet Central Banks, Noisy Markets

- The past several months have witnessed a remarkable contrast between quiet central banks and very raucous market-based central bank expectations. This note presents a quick analysis of this pattern.

- On the one hand, the U.S. Federal Reserve, the Bank of Canada, the Bank of England, the Reserve Bank of Australia, and the Bank of Japan have all been on hold since late April, representing four-plus months of inactivity for each.

- On the other hand, market expectations for the central banks have swung sharply, with an astonishing 100+bp range between the most optimistic and the most pessimistic market expectations over the period for each of the U.S., Canada, the U.K., and Australia.

- In conducting this analysis we look at central bank expectations in one year's time as computed using the OIS market. The TD Securities Global Monetary Policy Gauge allows for easy tracking of these statistics on a regular basis.

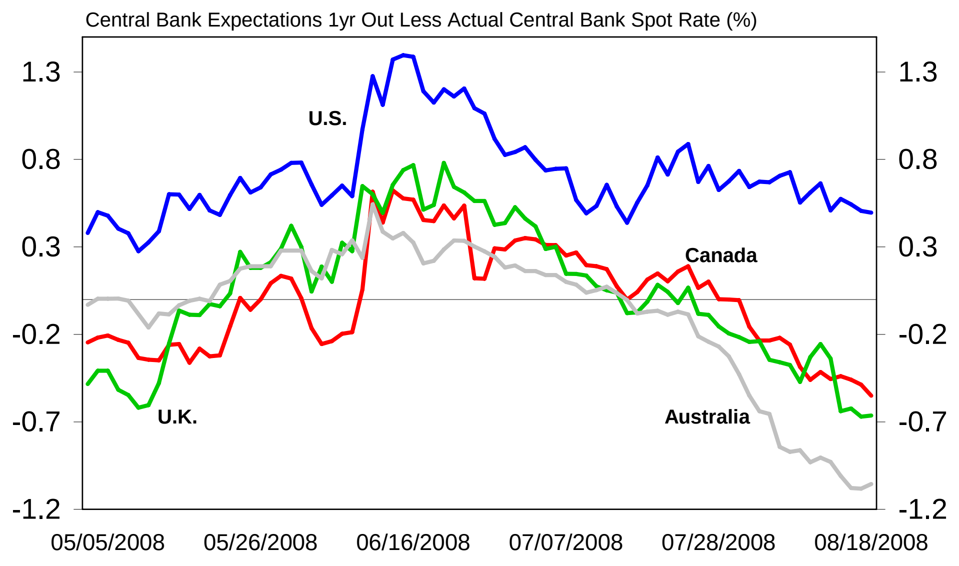
Stats to Ponder

- The market has actually flip-flopped between pricing in hikes and cuts for each of Canada, the U.K., Australia, and Japan over the past four months. Most profoundly, each of the first three countries has had extremes of more than 50bp of cuts and more than 50bp of hikes priced in at various points over the past four months.

- Equally astonishingly, Canada, the U.K., and Australia started May with cuts priced in, switched over to outright hikes by early June, and then reverted back to cuts by early August. This is not simply the case of things getting better and better or worse and worse. Expectations are truly churning.

- It is also instructive to note that, in the chart below, all four countries plotted have followed a generally similar trend. This speaks to the interconnectedness of markets, economies, and central banks around the world, and confirms our belief that the world remains very much coupled.

Follow The Leader



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Central Bank Expectations 1yr Out Less Spot Central Bank Rate
May 1 to Aug 21 (bps)

Country	Max	Min	Max-Min	Daily Avg Chg
U.S.	140	28	112	9
Canada	62	-55	117	7
U.K.	78	-67	145	8
Australia	54	-108	162	5
Japan	41	-5	46	3

So What?

- This note is intended more as an "isn't that interesting" piece than a "buy buy buy" proposal. Regardless, we can recap some useful implications here.

- First, central bank expectations can be extremely volatile even as central banks themselves are on hold. Periods of aggressive central bank hiking and cutting are not the only interesting times for the market.

- Second, and reflective of the churning back and forth in the market, we note that markets tend to repeatedly underestimate the degree of inertia at central banks. When central banks are hiking, they usually hike longer than the market expects. The same goes for cutting, and – as in the present example – for pausing. The market has refused to believe that the central banks would remain on hold, and yet – so far, anyway – they have.

- Third, and reflecting our usual Canada-U.S. focus, it is quite interesting to observe that although the central bank rates in Canada and the U.S. have been 100bp apart for the entirety of the last four months, market expectations have tended to call for the two central banks to have rates that converge on top of each other. We continue to believe that the depth of the U.S. problems far outweigh those in Canada, and thus that it is unlikely that this will come to fruition.

- From a purely Canadian perspective, the CA-US spread has varied by 78bp over the past four months, while the Canadian spread on an absolute basis has varied by 117bp. This suggests that 2/3 of the Canadian movement was independent of the U.S. market, while 1/3 was a consequence of U.S. movement. Given that the Canadian economy has an elasticity of about 0.5 to the U.S., this degree of independence from the U.S. is surprising, and it is not clear that it can continue indefinitely. We look for Canadian bonds to unwind some of this by underperforming the U.S. and to thus reverting to a somewhat more normal spread between the two.

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